IMMFA
INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

Mr Steven Maijoor
Chair
European Securities and Markets Authority
103, rue de Grenelle,
75007 Paris
France

29th January 2014

Dear Mr Maijoor,

Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues ("the Guidelines").

Request for delay & clarification of Compliance Date for Collateral Diversification Requirements.

Please find below IMMFA's response to the consultation on the revision of the provisions on diversification of collateral in the ESMA guidelines on ETFs and other UCITS issues ("the Guidelines").

As you will be aware, the transitional period in the Guidelines for existing UCITS funds will end on 18th February 2014 and existing UCITS funds will need to comply with the collateral diversification requirements in the Guidelines from that date.

In view of the profound uncertainty surrounding this issue, we would respectfully request that ESMA clarify and confirm a delay in the implementation date of the Guidelines until a suitable period after they have been finalised.

We appreciate your time and thank you for your consideration of this issue.

Yours sincerely,

Susan Hindle Barone
Secretary General

P.P.

Martin Curran
Chair IMMFA Investment Committee

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IMMFA's response to the consultation on the revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues ("the Guidelines")

IMMFA is a trade association representing managers of just over €430 billion of stable NAV money market funds based in Europe and their associated business partners. All the money market funds represented prioritise preservation of capital and liquidity and meet the ESMA definition of 'Short-Term Money Market Fund'. Furthermore the money market funds operated by members also adhere to a voluntary IMMFA Code of Practice which further determines their *modus operandi*, specifying tighter operating controls, with respect to liquidity limits for example, than are currently set out in the ESMA guidelines.

We would like to thank ESMA for the opportunity to respond to the ESMA Consultation Paper regarding the revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues (ESMA/2013/1974) ("the Consultation").

We believe that it is vital for the collateral diversification rules in paragraph 43(e) of the Guidelines to be changed. However, for the reasons outlined below in response to the specific questions, we do not fully agree with ESMA's proposal.

Responses to questions

1. Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of money market funds in the context of efficient portfolio management techniques and OTC transactions? If yes, do you agree with ESMA's proposal?

We agree that changes to para 43(e) of the Guidelines are required as money market funds are not able to operate effectively and efficiently under the current requirements of paragraph 43(e) of the Guidelines.

Reverse repurchase transactions ("reverse repo") are an important efficient portfolio management technique used by money market funds. Money market funds use reverse repo as a secure means of investing cash, and in return receive high quality collateral thereby mitigating their bank credit risk. The vast majority of reverse repos entered into by money market funds are overnight transactions, that is, the primary exposure of the money market funds to the reverse repo counterparty and the contingent exposure to a particular collateral portfolio are of overnight duration. Consequently, the risk of default of the counterparty or amongst the collateral securities is minimal. Reverse repo provides a critical tool for money market funds, and in particular Government money market funds, to provide liquidity on a daily basis to meet investor redemptions.

Ultimately, in order to manage a daily maturing element of the overall portfolio without reverse repo, money market funds (in particular Government money market funds) would have no alternative but to sell investments in the market before maturity to meet investor redemptions. This challenges the viability of these funds because they would be exposed to the risk of having to transact in the securities market for same day settlement when the market standard is T+2 days. The need to manage liquidity by trading presents an undue exposure to the willingness and ability of counterparties to trade on a non-standard basis and would undoubtedly lead on to poor prices being quoted for the securities with the fund in effect being a forced seller.

Collateral received under reverse repo need not be diversified in the same way as the investment portfolio of the money market fund, as they serve different purposes, which should not be confused. In a reverse repo the role of the collateral is to mitigate the primary performance risk of the counterparty. In the unlikely event of an overnight reverse repo counterparty default, the money market fund may liquidate the collateral received in the market in order to recover the cash which had been loaned to the defaulting counterparty. In the investment portfolio however, risk diversification applies to spread the investment risk across assets. We firmly believe that good credit quality and liquidity rank above diversification in terms of delivering optimal investor protection in the event that the manager has to call on collateral to make good the fund's position in the event of counterparty default.

Money market funds adopt rigorous processes to select counterparties and suitable high quality collateral. The current requirement to diversify the collateral in accordance with paragraph 43(e) of the Guidelines may mean that investors are less protected in a case of a counterparty default as in order to diversify, managers may be required to hold collateral which (although under para 43(c) of the Guidelines is of high quality) is not as high quality as holding 100% in UK Government T-Bills or Gilts for example.

Typically, money market funds appoint a specialised third party agent to administer the securities received as collateral from counterparties as part of reverse repo trades. The convention when entering into a reverse repo is for the counterparty to be given the collateral composition requirements of the fund (for example, specifying which Government and agency debt is acceptable and predefining risk limits). This process allows flexibility in operation and enables the counterparties to actively manage their asset inventory. A consequence however is that the precise make-up of the collateral pledged each day by any given counterparty is not known by a fund until some time after the close of dealing.

The custody systems operated by the main specialist third party agents, such as Euroclear, Bank of New York Mellon, JP Morgan Chase and CREST for example, do not have the functionality to support diversification or aggregation of collateral. This was not previously a problem where collateral needed to be of high quality and liquid. The current collateral diversification and aggregation requirements of paragraph 43(e) of the Guidelines and the proposed new requirement to diversify Government securities across at least six different issues presents profound practical difficulties in entering into tri-party reverse repo. This will make reverse repo very difficult if not impossible for money market funds to transact.

There are certain Government money market funds which have the objective to obtain exposure only to a specific Government or sovereign (for example, Sterling Government funds). Complying with the current collateral diversification requirements of para 43(e) of the Guidelines would not be possible for these funds, and they would either have to close, amend their investment objective and policy or reduce the use of reverse repo to no more than 20% of the net asset value of the fund. This is likely to impact the effective and efficient operation and possibly the yield achieved by the fund, which would not be in the investors' interests.

Although we believe that collateral should be treated differently from the investment portfolio as we outline above, it is important to note that the UCITS directive allows all UCITS to invest 100% of their assets in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong (Article 54 (1)). If the property of a UCITS fund can be so invested, it does seem appropriate that the collateral held by a UCITS could be 100% in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong.

Therefore, for the reasons set out above, we support the change to paragraph 43(e) of the Guidelines to remove the collateral diversification requirement in respect of Government securities across issuers for money market funds.

However, we do not agree with the proposed requirement to diversify the Government securities across at least six different issues and would request also that the requirement to aggregate collateral across different counterparties be removed. This is because, as outlined above, the collateral received under reverse repo should not be required to be diversified in the same way as the investment portfolio of the fund due to the different purpose collateral serves, and in addition, these requirements will make it practically impossible for money market funds to continue to use reverse repo.

We would ask ESMA to reconsider this and remove the requirements to diversify the Government securities across six different issues and the requirement to aggregate collateral across different counterparties.

2. Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification? Please give reasons for your answer.

We do not think that ESMA should introduce additional safeguards for Government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification for the reasons outlined in our response to Question One above.

3. Do you agree with the proposed requirement to diversify the government securities across at least six different issues?

We do not agree with the proposed requirement to diversify the Government securities across at least six different issues for the reasons outlined in our response to Question One above.

We would welcome any further discussion on any of the points that we have raised.

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